momentum

Perspectives on Fixed Income Investing: Instalment 1 – The Overview

INTRODUCTION

Over the past few years, many of the new ideas that institutional investors have introduced into their portfolios have stemmed from the fixed income world. In particular, investors have either introduced or increased allocations to various flavours of sub-investment grade credit in their search for yield and to further diversify risky asset exposures.

In this series of short notes, we summarise our views on fixed income investing for UK-based pension funds with sterling liabilities. For these clients, fixed income assets serve two purposes:

1. They can provide liability hedging characteristics; and/or

2. They can provide a source of excess return (over risk-free assets[1]).

It has become increasingly common for liability hedging characteristics (i.e. sterling interest rate sensitivity and/or sensitivity to UK inflation) to be managed by a dedicated liability hedging (LDI) manager. Therefore, this is not the reason for introducing dedicated fixed income mandates into a client's investment policy. Rather, it is because these portfolios can generate excess returns that are not perfectly correlated with equity returns (or other risky asset returns) that they are useful to clients. We focus on this aspect of fixed income investing in this series of notes.

SOURCES OF EXCESS RETURN

The sources of excess return that can be derived from fixed income investments are often bundled up, and investors commonly form a view on whether the packaged investment is attractive or unattractive (strategically and/or on relative valuation grounds).

Our preference is to decompose the overall return available from an investment into its component parts, and to consider each component on its own merits. This approach has two key benefits. Firstly, it ensures that attractive return sources are not missed, simply because they are bundled up with unattractive sources. And secondly, it provides the scope to invest more precisely to target only the attractive return sources.

The sources of return that we focus on in the fixed income universe are:

1. Term premia (both sterling and non-sterling)
2. Credit risk premia
3. Liquidity risk premia
4. Currency risk premia
5. Active risk (or 'alpha')

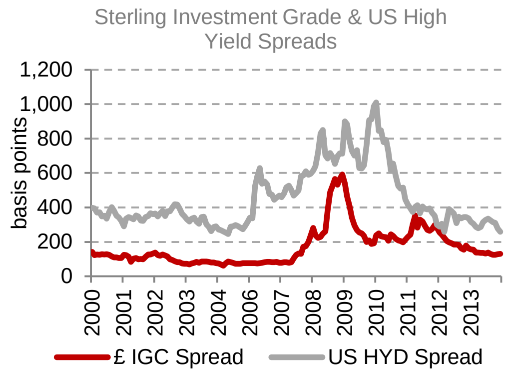
There are other ways of describing the sources of return available (e.g. carry, momentum, value) but we believe these can all be captured by one or more of the five sources listed above.

We will consider each of these sources of return in detail in future instalments. In this first note, we provide a brief overview of the range of fixed income strategies available, and summarise their exposures to the five sources. We also comment on how clients can build diversified fixed income portfolios which give them exposure to all five sources.

CURRENT MARKET ENVIRONMENT

Forward looking excess returns from fixed income investments in developed markets have diminished considerably as yields have fallen and credit spreads have narrowed. This has been driven by and large by a re-pricing of interest rate expectations, credit risk and liquidity risk.

[1] Risk free in this instance refers to cash and/or gilts



In light of the current environment, clients may well be reviewing their fixed income allocations. We believe there is merit, therefore, in considering the range of return drivers from these allocations and what they add to client portfolios.

RANGE OF FIXED INCOME STRATEGIES

The fixed income universe has a bewildering range of different strategies. Some of these can provide precise exposure to one source of fixed income excess return, but most provide exposure to multiple sources. The chart below lists the different strategies, and summarises the sources of expected excess return that they currently provide. A brief description of each strategy is included in the appendix.

It is important to bear in mind that the magnitude of each of the exposures shown is subjective, and that each strategy can come in many different forms.

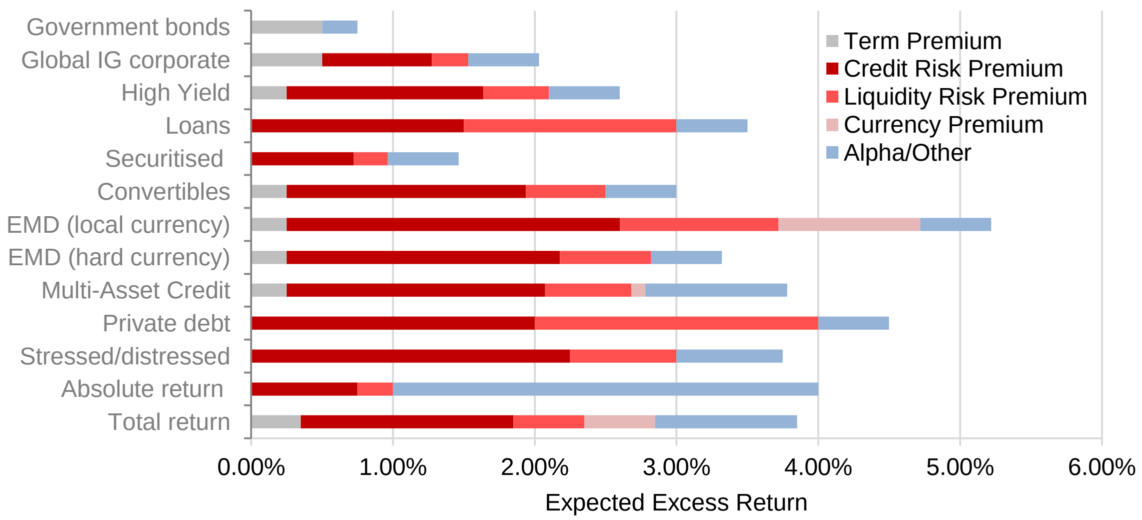
For example, the following aspects of investment grade credit mandates can vary significantly:

1. Opportunity set: can be sterling focused issuance, or international (predominantly USD and Euro).

2. Exposure to the term premium: can be short-dated, long-dated, or can have interest rate risk hedged out. In the chart below, we have assumed that the interest rate risk is retained.

3. Extent of active management: can be passive, fully active, or somewhere in between (e.g. buy and maintain). In the chart below, we have considered a fully active credit strategy, but not one able to express global macro views (such as relative value country views or currency views). Similarly, for other strategies, we have shown how rich the opportunity set is for active management of the securities in the specific strategy.

4. Currency risk: for international credit mandates, the currency risk can either be retained or hedged. We have assumed that the exposures to non-sterling currencies would be hedged back to sterling for all strategies other than Local Currency EMD.



CONSTRUCTING DIVERSIFIED FIXED INCOME PORTFOLIOS

We believe it is beneficial to include exposures to each of the five sources of excess return in client portfolios. We also believe that there can be sufficient variety within a single source of excess return to make it worthwhile including multiple strategies which target the same source.

For example, both investment grade bonds and high yield bonds provide exposure to the credit risk premium, but they provide exposure to different types of corporate issuers and industries and hence to different types of credit risk, and so we would favour including both. In general, our preference is to seek exposure to the broadest possible opportunity set. However, it is arguably less valuable to include strategies such as high yield if they can be adequately covered by other broader strategies (such as multi-asset credit).

In constructing a diversified fixed income portfolio, consideration will need to be given to:

- Risk and return objectives: clients with a higher return objective would likely include higher allocations to higher yielding strategies;
- Capital constraints: limits the extent to which capital can be tied up in lower returning strategies such as investment grade credit, in which case consideration could be given to synthetic structures;
- Conviction in the various components of excess return: e.g. clients may have greater conviction in being paid for taking credit risk relative to taking term risk;
- Liquidity requirements: attitudes to liquidity vary considerably, but factors to take into account include: net cash-flow requirements, collateral requirements and flexibility requirements (i.e. the need or desire to be able to change strategy or manager);
- Other growth asset allocations: For example, allocations to emerging market equities could limit EMD allocations if there is a desire to limit the overall allocation to emerging markets, and allocations to hedge funds may overlap with absolute return bond strategies;
- Governance: impacts the complexity and number of strategies that could reasonably be included.

SUMMARY

In this first note, we have:

- Identified the main sources of excess return that can be derived from fixed income investments;
- Observed that the forward looking returns available from credit risk and liquidity risk are lower now than they have been in the recent past; and
- Listed the main types of fixed income strategy available to investors, and summarised their sensitivities to the main sources of return.

Given the current market environment, we believe that it is appropriate for clients to review their exposures to different fixed income sources of return. It is undoubtedly the case that the reward available from many market betas is lower now than it has been for much of the last five years. Against this backdrop, we believe there is a good case for clients to consider adjusting the balance between beta risks (such as credit risk) and active risk to put more emphasis on the latter.

In future notes we will consider the various sources of return in detail, and explain why they are all sources of return that can be useful in a pension scheme portfolio.

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Appendix

In the table below we set out a brief description of the fixed income strategies referred to in this paper:

Strategy	Description	Fixed/ Floating Rate*
Government bonds	• Debt issued by the governments of developed countries. Generally considered to be low risk.	Fixed
Investment grade credit/aggregate bond	• Debt issued by companies (including debt issued by supranationals and government backed agencies). • The company issuing the debt must been assigned a credit rating of BBB/(Baa) or higher.	Fixed
High Yield bonds	• Debt issued by companies, which have been assigned a credit rating below BBB/(Baa), often referred to as sub-investment grade. • Includes debt issued in hard currency by corporates based in emerging market countries. • These bonds generally offer a higher yield than investment grade bonds because of the higher risk of default.	Fixed
Loans	• Typically, bank loans made to sub-investment grade companies. • Loans have more restrictive covenants than high yield debt and are typically more senior in the capital structure i.e. the loans holder will be paid back before the holder of the high yield debt.	Floating
Securitised	• Debt issued by financial institutions where the cashflows are based on a pool of underlying loans, which could include mortgages, credit card receivables, student loans etc. • The debt is often structured into different tranches where the tranches have different credit risk characteristics. • Senior tranches are often assigned an investment grade rating whilst the most junior tranches can be equity like.	Floating
Convertibles	• Debt issued by companies, where the holder has the option to trade in the bond for shares in the company, should the share price rise sufficiently. • Because of the embedded equity call option, the yield should be lower than an equivalent bond with no conversion option.	Fixed
Emerging Market Debt (local currency)	• Debt issued by the governments of emerging market countries in the local emerging market currency. • Tends to be higher quality than EMD hard currency because only countries which are sufficiently financially robust are able to issue debt in local currency.	Fixed
Emerging Market Debt (hard currency)	• Debt issued by the governments of emerging market countries in hard currency, typically USD or Euro.	Fixed
Private Debt (corporate, real estate, infrastructure)	• Debt issued by private entities. • These loans are typically privately negotiated and are not tradeable and the investor is therefore locked in over the term of the loan. • Senior secured, mezzanine or junior. • Investors typically access these investments through closed ended funds which have a fund life of c. 7-10 years.	Floating
Stressed/ distressed/ opportunistic	• Debt issued by companies that have filed for bankruptcy (distressed) or are going through some financial restructuring (stressed). • Strategies aim to invest in the debt at a very low price and to sell out at a higher price after the restructuring has taken place. • Often illiquid and difficult to trade over the restructuring period.	Fixed

Multi-Asset Credit	• Strategies that invest across the universe of tradable fixed income assets (e.g. high yield, loans, securitised, stressed etc.) but typically with a focus on sub-investment grade debt. • Strategies are often distinguished between those that include an allocation to EMD and those that don't. • Asset allocation decisions across the different asset classes are expected to be key component of added value.	Both
Absolute return	• Unconstrained strategies that aim to generate positive returns from fixed income markets regardless of whether markets are going up or down.	n/a
Total return	• Unconstrained strategies that invest across fixed income markets (including government bonds, investment grade and sub-investment grade) with the objective of achieving good positive returns. However these strategies may have a strategic exposure to the term premium and to credit beta and therefore could underperform cash in an environment of rising yields and/or widening credit spreads.	Both

* Denotes the nature of the majority of the debt included for each strategy. There will of course be exceptions.